

403(b)TAX-SHELTERED ANNUITY PLANS



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Announcer: Meet Mike, who works for the ABC School District as the administrator of ABC's 403(b) Tax-Sheltered Annuity Plan.

Today, Mike is meeting with an IRS representative, Bob, to go over some questions he has about the school district's 403(b) plan. Let's listen in...

Mike: Hi Bob, thanks for meeting with me today. I help ABC School District administer its 403(b) plan, and I had some questions for you so I can ensure our plan remains compliant with tax law.

Bob: It's nice to meet you Mike and I'm glad to hear that your district understands the need to pay attention to the operation of its 403(b) plan to ensure it is in compliance with the law.

General Effective Date

Taxable years beginning after **12/31/08**

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Mike: I understand that there have been some recent changes in the law that might impact our plan. When do these changes become effective?

Bob: Yes, the IRS has issued regulations that affect 403(b) plans. The general effective date is for taxable years beginning after 12/31/08.

Written Program Requirement

- A 403(b) plan must be maintained pursuant to a written program
- Does not require plan “document”
- Written program can ‘bundle’ together several documents
- Both form and operation satisfy 403(b) and contain all terms & conditions for eligibility, limitations and benefits under the plan

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Mike: The law requires a 403(b) plan to be in writing now, right?

Bob: That's right. You must now have a written program containing all terms and conditions of the plan.

It doesn't have to be difficult to establish the written program, because nowhere in the regulations does it say you need a single plan document!

A written program can consist of bundling the salary reduction agreement, summary plan description, custodial account, annuity arrangement, and any other plan documents you may already have in place.

Of course, once you have a written program, make sure you know what it provides and follow its terms in operating the plan.

Effective Date for Written Program Requirement

Original effective date of 01/01/09 is extended if:

- Written program adopted on or before 12/31/09 that intends to satisfy 403(b), including the regulations;
- During 2009, the program operates in accordance with a reasonable interpretation of 403(b) and the regulations; and
- On or before 12/31/09, best efforts are made to retroactively correct operational failures during 2009 to conform with the written program (could require restoration of benefits)

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Mike: Okay, so what's the deadline for having the written program in place?

Bob: Initially, plans were required to satisfy the written program requirement by January 1, 2009.

However, because not everyone was ready, the IRS extended the deadline to December 31, 2009— IF during 2009, the plan operates in accordance with a reasonable interpretation of section 403(b) and the regulations; AND, on or before December 31, 2009, best efforts are made to retroactively correct operational failures during 2009 to conform with the final written program.

"Best efforts" means that the participants have to be placed in the same position that they would have been in had the failure not occurred. This could require a restoration of benefits to participants.

The Written Program— Essential Elements

- Eligibility (non-discrimination rules)
- Benefits
- Dollar limitations
- Available investments
- Form and timing of distributions

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Mike: What exactly does this written program need to contain?

Bob: There are a number of essential elements that are required.

The written program must set forth the eligibility rules. If the plan provides matching or nonelective contributions, eligibility for those contributions must be explained in the written program.

The formulas for determining the contributions and benefits for each participant must be set forth along with any dollar limitations that may restrict the amount of contributions or benefits a participant could receive.

The types of investments available under the plan must be addressed, such as whether annuity contracts and/or custodial accounts are the investment vehicle for participants.

Finally, the various forms of distribution, such as lump sum, life annuity, etc., must be in the written program as well as when a participant can receive a distribution.

The Written Program— Optional Provisions

If your 403(b) plan includes these optional provisions they must be explained in the written program:

- Loans
- Hardship distributions
- Auto enrollment
- Designated Roth contributions

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Mike: Can our written program contain other provisions?

Bob: Yes, a 403(b) plan can have optional provisions, but in that case the written program must also explain those provisions. For example:

If loans are available, the written program must explain how a participant can get a loan and any restrictions on the availability or amount.

If hardship distributions are available, the written program must state that, define the conditions that must be met, and explain any restrictions on the amount.

If the plan has automatic enrollment, the written program must state that, and explain the procedure for an employee to opt out. (Automatic enrollment provides that every eligible employee is automatically enrolled and will make a salary deferral to the plan.)

If the plan allows designated Roth contributions, the written program needs to state that an employee can elect to treat his or her salary deferrals as a designated Roth contribution. (A designated Roth contribution is an after-tax contribution and when the contribution and related earnings are distributed to the employee, they are usually tax-free.).

The Written Program— Additional Optional Elements

- Elective deferral catch-ups for those with 15+ years of service or age 50+
- In-service exchanges or transfers
- Employer's right to terminate plan
- Five-year provision for retired/terminated employees

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Bob: Other optional provisions can include special catch-up elective deferral contributions for employees who have 15 or more years of service or who are age 50 or over. If the plan allows these, the written program must define the conditions for making such contributions.

If the written program provides for in-service exchanges or transfers between plans, the written program must contain language about the timing of such exchanges or transfers, and any conditions imposed for making an exchange or transfer.

If the employer reserves the right to terminate the plan, language giving the employer that authority needs to be in the written program.

If the employer intends to make nonelective contributions on behalf of retired and/or terminated employees for the five-year period following severance of employment, the written program must state the availability of this feature.

General Salary Deferral Limit

- General salary deferral limit: lesser of 100% of includible compensation or \$16,500 (for 2009)
- Increased under 15 year special rule (years of service=employee's annual work period/not taxable year)
- Increased for employees age 50 or older

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Mike: Has the amount that employees can contribute to a 403(b) plan changed?

Bob: For 2009, the general salary deferral limit for employees is the lesser of 100% of includible compensation or \$16,500.

If the written program allows for optional catch-up contributions for employees who have worked for your organization for 15 or more years, they may make additional contributions of up to \$3,000 for up to five years. (The complete formula for determining this amount is contained in the regulations and IRS Publication 571).

Remember under the 15 year special rule, a year of service is based on an employee's annual work period and not a taxable year.

Also, if your 403(b) plan allows this, an employee who is age 50 or older may make an additional contribution of \$5,500 for 2009

Nonelective Contributions for Former Employees

- Nonelective employer contributions through the end of the taxable year of severance plus the next five taxable years after employment
- No additional contributions after death

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Mike: Can our 403(b) plan still contribute on behalf of retired employees?

Bob: Yes, an employer may make nonelective contributions to the plan on behalf of a retired and/or terminated employee through the end of the taxable year of severance plus the next five taxable years.

Salary Deferral Contributions by Former Employees

From any regular wages or wages representing accrued but unused vacation and/or sick days by the **later** of :

- 2 ½ months from the date of severance, or
- the end of the year in which the employee severs employment

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Mike: Can the former employee still make contributions?

Bob: Yes, a former employee can continue making salary deferral contributions to the plan, but only from any wages that have not been paid or made available, or from any wages that are for accrued but unused vacation and/or sick days.

Also, these contributions must be made by the later of 2 ½ months from severance, or the end of the year in which the severance occurs.

Elective Non-Discrimination/ Universal Availability

If plan allows employee elective deferrals, must give all employees (other than employees in a permissively excludible group) effective opportunity to make these deferrals.

- Effective opportunity
 - Meaningful notice
 - Right to make salary deferrals
 - Election timing

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Mike: Okay I have been hearing about this term “universal availability.” What does it mean?

Bob: “Universal availability” is also known as “elective non-discrimination” and means that if an employer permits one employee to defer salary into a 403(b) plan referred to as an employee elective deferral, the employer must extend this offer to all employees of the organization, other than those in a permissively excludible group.

Universal availability also requires the plan to give meaningful notice to employees of their right to make elective deferrals. The notice may be electronic or in the form of a hard copy and must notify the recipients of:

their right to make elective deferrals;
when to make an election; and
how many times and when during the year they can change that election.

A 403(b) plan may not condition an employee’s right to make elective deferrals on making a separate election under another plan. For example, the plan sponsor cannot require that an employee take out a certain level of health insurance before being allowed to make elective deferrals to the 403(b) plan.

Universal Availability - Permissive Exclusions

- Non-resident aliens
- Students
- Employees who will contribute \$200 or less annually, are eligible under other deferral plans, and/or normally work less than 20 hours per week

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Mike: So certain employees can be excluded and still not violate the universal availability requirements?

Bob: Yes, a 403(b) plan may exclude employees from making elective deferrals and still satisfy universal availability.

The permissively excluded groups include non-resident aliens and students, as well as those employees:

who will contribute \$200 annually or less,
who participate in a 401(k) or 457(b) plan, or in another 403(b) plan,
and/or
who normally work less than 20 hours per week.

(Note that "less than 20 hours per week" does not necessarily mean all part-time employees and requires special analysis).

20 Hours Per Week

Guideline for determining if an employee works < 20 hours/week so that they can be permissively excluded from universal eligibility:

On date of hire, employer must reasonably expect employee to work < 1000 hours for ensuing 12-month period.

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Bob: For purposes of determining which employees work fewer than 20 hours per week, at the time an employee is hired, the employer must reasonably expect that employee to work fewer than 1,000 hours in the ensuing year.

This rule commonly applies to permanent substitute teachers, bus drivers, cafeteria workers, janitors, etc., to determine if each is eligible to make elective contributions to the 403(b) plan.

Hardship Distributions

Hardship distributions

- Immediate and heavy financial need
- Amount is necessary to satisfy the immediate and heavy financial need

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Mike: Can a 403(b) plan offer a hardship distribution?

Bob: Yes, your plan may provide for hardship distributions.

A hardship distribution must be made on account of an immediate and heavy financial need of the employee and the amount must be necessary to satisfy the financial need. The need of the employee includes the need of the employee's spouse, non-spouse dependent, or dependent or non-dependent beneficiary.

Whether a need is "immediate and heavy" depends on the facts and circumstances. Certain expenses are deemed to be immediate and heavy, including:

certain medical expenses;
tuition and related educational fees and expenses;
burial or funeral expenses;
costs relating to the purchase of a principal residence;
payments necessary to prevent eviction from, or foreclosure on, a principal residence; and
certain expenses for the repair of damage to the employee's principal residence.

A distribution is deemed "necessary to satisfy an immediate and heavy financial need" of an employee if the employee has obtained all other

Loans

Employee:

- May borrow greater of \$10,000 or 50% of the account balance (maximum of \$50,000)
- Must pay interest on the loan
- Must repay within 5 years in most cases

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Mike: Can a 403(b) plan offer loans?

Bob: Yes, 403(b) plans can allow loans but there are some restrictions.

For example, employees may only borrow the greater of \$10,000 or 50% of the account balance, must pay interest on the amount borrowed, and in most cases, must repay the loan within five years.

Deadline for Depositing Elective Deferrals

Contribution amounts must be transferred to providers within a period no longer than is reasonable for proper plan administration.

For example, employers must transfer elective deferrals within 15 business days following the month in which these amounts would have been paid to the participant as wages.

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Mike: What is the deadline for depositing employee elective deferrals for a 403(b) plan?

Bob: I am glad you asked this question since the IRS receives many calls from participants complaining about their elective deferral monies not being placed in their annuity/custodial accounts in a timely fashion. Thus, a rule was included in the 403(b) regulations requiring employers to transfer elective deferrals within a period no longer than is reasonable for proper plan administration.

Old Rules for Exchanges

- Old Rule: Revenue Ruling 90-24 –
annuity-to-annuity exchanges
with no employer involvement

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Mike: Have the rules for contract exchanges for 403(b) plans changed?

Bob: Yes they have. An example of a transfer under the old rules involves a teacher who does not like any of the investment options currently available under the 403(b) plan. The teacher, on his or her own, invests his or her funds in an annuity contract that the employer has not recognized. Revenue Ruling 90-24 permitted this type of investment without jeopardizing the tax-free status of the teacher's retirement funds.

The New Exchange Rules

- Plan permits
- Benefit not diminished
- Undiminished distribution restrictions
- Employer and issuer enter into information sharing agreement for exchanges outside plan

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Bob: The new rules still permit these types of exchanges. The contracts of the vendor that are not currently part of the 403(b) plan will require the vendor to enter into an information sharing agreement with the employer so that no provisions of the written program will be violated and cause the employee's retirement funds to become currently taxable.

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Mike: I want to thank you so much for your time. I just want to know one more thing. Does the IRS have resources available on 403(b) plans that I can consult from time to time?

Bob: Absolutely, you can find out more about 403(b) plans by going to the IRS's website, www.irs.gov.

Click on Retirement Plans Community at the top, then Types of Plans on the left, and finally 403(b) plans in the center.

The IRS also puts out several publications specifically about 403(b) plans such as 571 and 4483 that you can view online or download. Just type 571 or 4483 in the search box to find them.